SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 668

MANUFACTURERS TRUST COMPANY,
Petitioner,

vs.

THE UNITED STATES.

ON PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

BRIEF FOR PETITIONER MANUFACTURERS TRUST COMPANY.

Specification of Errors to be Urged.

It is submitted that the Court of Claims erred:

1. In holding that the tax, *as applied,* upon the gains from the profitable silver sales without allowance of losses on related unprofitable silver sales, is a valid income tax; and in not holding that the tax, as so applied, is a tax on gross receipts and therefore a direct tax on capital and not a tax on income within the meaning of the 16th Amendment.

2. In holding that the decision in *United States* v. *Hudson*, 299 U. S. 498, established that the silver tax, as applied in this case, is valid as an income tax.

3. In holding that the silver tax is not a tax levied on property because of its ownership, but one levied upon the use made of the property, and that it is a valid indirect or excise tax, and in not holding that the right of disposition by every owner of a commodity and his right to the proceeds thereof, is an inherent and essential incident of ownership, and that a tax on such disposition and proceeds is a tax on ownership.

4. In holding that a tax on the profit from each sale of silver bullion, without regard to whether the vendor is engaged in the fabrication, use, or sale of silver bullion as a business, is a valid excise under Article I, Section 8, of the Constitution.

5. In construing the Statute and applying it to the facts in this case so as to hold that there were several interests in silver separately transferred.

6. In holding that the item of legal expense was correctly disallowed as a deduction in computing the tax.

Authorities and Argument.

A. As Applied in This Case, the Silver Tax Is Not a Tax on "Income" Within the Meaning of That Term in the 16th Amendment.

The 16th Amendment became necessary because of the ruling in the *Pollock* case that a tax upon the income from property is a direct tax and therefore subject to the provisions of Article I, Section (2) of the Constitution requiring apportionment. The 16th Amendment simply removes

this limitation in the imposition of a tax upon "incomes, from whatever source derived."

A tax upon the profits from the sale of personal property is a direct tax.[1]

It follows, therefore, that a tax upon the proceeds of sale of personal property, if not limited to income derived therefrom, does not come within the scope of the 16th Amendment, and therefore remains subject to the requirements of apportionment.[2]

The word "income" is used in the 16th Amendment in its ordinary and commonly understood sense.[3]

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[1] *Eisner* v. *Macomber*, 252 U. S. 189 at 205; *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1.

[2] In *Eisner* v. *Macomber*, 252 U. S. 189, this Court said (at page 206):

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

"In order, therefore, that the clause cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, * * * For the present purpose we require only a clear definition of the term 'income', as used in common speech, in order to determine its meaning in the Amendment."

See also *Merchants L. & T. Co.* v. *Smietanka*, 255 U. S. 509.

[3] In *Merchants L. & T. Co.* v. *Smietanka*, 255 U. S. 509, this Court said (at page 519):

"In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the 16th Amendment to the Constitution."

When a special tax is sought to be sustained as an income tax it must first be determined whether the subject of the tax is true income within the scope of the 16th Amendment. This requires an analysis of the meaning of the word "income" as used in the 16th Amendment. Was it intended that Congress should be empowered to tax only that which has always been understood to be income in the ordinary sense of the term, or is Congress free to determine for itself what constitutes income? The answer to this question is clearly supplied in *Eisner* v. *Macomber* (see note 2, *supra*).

The silver tax, as applied in the case at bar, is not a tax on "income". The method of determining income from sales of property for ordinary income tax purposes is to be found in Sections 22, 111, 113 and 117, Internal Revenue Code. Neither this method nor any commonly accepted method of determining income is observed in arriving at the tax base for computation of the silver tax.

The silver tax as applied in this case is not based upon any reasonable periodic accounting of profits from transactions in silver, nor does it have any relation to the existence or non-existence of such profits. The existence of profit as determined by some reasonable periodic accounting is fundamental to the concept of income.

If isolated silver gains can be taxed as "income" then Congress could likewise isolate gains from the profitable transactions in any mercantile business and impose an income tax on such gains, regardless of what the actual profits were, and even though the taxpayer may not have recovered its capital outlay in the cost of merchandise it had sold in any period. If Congress could do that, the shoe store proprietor could be compelled to pay an "income tax" on the proceeds of sale of only those shoes that are sold at a profit, without any regard for any sales of shoes at a loss, and without any regard for what his actual profits during any

period are, or, in fact, whether he has any profit at all. Such tax would not be a tax on income but on gross receipts or on capital; and, whether in the guise of an income tax or an excise, would be a direct tax on the property from which the gross receipts were received or on the capital, and would be invalid for lack of apportionment.

It may be further observed that the Treasury Department itself has recognized that the silver tax is not an income tax, in ruling that it is deductible in computing net taxable income for income tax purposes.[4]

Other Treasury rulings construing similar and analogous taxes of foreign countries have uniformly held that they are not income taxes for the purpose of permitting a credit under such provisions as Section 131 I. R. C.[5]

This Court has consistently construed the term "income" in various statutory contexts in its application to proceeds of sales of property as including only the proceeds in excess of cost of the property.

In the Corporation Excise Tax Act of August 5, 1909 (effective January 1, 1909) a tax was imposed upon all corporations for the privilege of doing business, based upon a certain percentage of the "income" of such corporations. This was sustained as an excise; but in so doing, this Court found it necessary to construe the word "income" in various applications. In *Doyle* v. *Mitchell Brothers Company*, 247 U. S. 179, the taxpayer had purchased timberlands in

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[4] I. T. 2899, June 1935, Cum. Bull. XIV-1 p. 67. In construing the application of Sec. 23 (c) of the 1934 Revenue Act permitting the deduction, in computing net taxable income, of "taxes paid or accrued within the taxable year, except (1) Federal income, war profits, and excess profits taxes * * *," the Treasury held that the silver tax is a stamp tax, not an income tax, and therefore deductible.

[5] See particularly I. T. 3193, Cum. Bull. 1938-1 p. 193, dealing with Art. 14 of the 1934 Mexican Tax Law; I. T. 3211, Cum. Bull. 1938-2, p. 177, dealing with taxes of certain Canadian Provinces; I. T. 2909, Cum. Bull. XIV-2-136 (1935), dealing with the Quebec Mining Act.

1903 at $20.00 per acre. On December 31, 1908, the stumpage value was $40.00 per acre. In determining income for the years 1909 to 1912, inclusive, under the Corporation Excise Tax Act, the taxpayer deducted from gross receipts the market value of stumpage as of December 31, 1908. The Commissioner assessed the tax on the basis of the original cost of the land as of 1903.

In this Court the Solicitor General argued that the "income" subject to tax should be determined by treating the entire proceeds of a conversion of capital assets as income.

This argument was rejected by the Court in a passage which is of vital significance in the case at bar.

> "Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income', it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'
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> "Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrived at 'net income'. *In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.*" (Italics supplied.) (Pp. 184, 185.)

In *Goodrich* v. *Edwards*, 255 U. S. 527, the question was whether taxable gain on the sale of stock was to be determined as against the actual cost, or as against the value on March 1, 1913, which, under the statute, was fixed as the basis for determination of gain or loss. The purchase price of the stock in 1912 was about $291,600. The value as of March 1, 1913, was about $148,000. The selling price in 1916 was about $269,000. This Court held that an assessment based upon the difference between the selling price and the March 1, 1913 value was erroneous, saying:

> "It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor; * * *." (Court's italics.)

The right to recoup cost upon the sale of personal property in determining "income" does not involve the question of allowable deductions. It is established beyond question that Congress may, in its discretion, deny the taxpayer the right to deduct the loss sustained in one class of transactions as against income from another class of transactions; and a reasonable classification by Congress consistent with sound accounting would not be disturbed.

Here we have no such question, as the losses occurred not only within the same class of transactions as the profits, but, as discussed below, within the confines of a single transaction (see pp. 21-23, *infra*). To hold that such losses are not to be taken into consideration in determining taxable income runs afoul of the constitutional limitation that an unapportioned direct tax must be limited to "income". This does not involve the rule that deductions are within the discretion of Congress.

This Court has in various connections applied sound accounting practice and common sense to the interpretation of the term "income". For example, in *Woolford*

Realty Co. v. *Rose,* 286 U. S. 319, in considering the meaning of the word "income" in the loss carry-over provisions of the Revenue Act of 1926, this Court said that a corporate net loss may not be deemed income.[6]

Again, in *Walsh* v. *Brewster,* 255 U. S. 536, this Court held that no tax was assessable with respect to the proceeds of sale of certain stock, even though at a price above the March 1, 1913, value, "* * * since the owner of the stock did not realize any gain on his original investment * * *" (255 U. S. at 537).

In short, upon the sale of property there can be no "income", and hence no constitutional basis for an income tax, unless and until the cost has been recouped. This is stated by Magill in his work on "Taxable Income" (1936), as follows:

> "In the case of a sale of property having a known cost, the only income is the excess, if any, of the sale price over the cost. Income, therefore, does not mean gross receipts" (p. 305).

This Court did not, in *U. S.* v. *Hudson,* 299 U. S. 498, determine that for all purposes and in all its applications the silver tax is a valid income tax. In that case all of the silver transactions of the taxpayer were profitable. It is to be observed that in its opinion in the *Hudson* case this Court used the term "special income tax." The Government, in its brief in this Court in the *Hudson* case, did not

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[6] "There are two fundamental objections to this method of computation. In the first place, an interpretation of net income by which it is also a net loss involves the reading of the words of the statute in a strained and unnatural sense. The metamorphosis is too great to be viewed without a shock. Certainly the average man supporting a net loss from the operations of his business would learn with surprise that within the meaning of the Congress the amount of his net loss was also the amount of his net income. 'The popular or received import of words furnishes the general rule for the interpretation of public laws.' *Maillard* v. *Lawrence,* 16 How. 251, 261; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 560." (*Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 327.)

argue that the silver tax is an income tax for all purposes;[7] though it did inaccurately claim that it was a tax on net profits only.

In any event, the characterization of the tax by this Court in the *Hudson* case, in connection with its retroactive features, does not preclude re-examination of the subject in connection with other applications of the tax.

It is submitted that even if the sale of the silver bullion by petitioner in instalments was properly interpreted as the sale of several interests the tax as applied was not upon income within the meaning of the 16th Amendment.

B. The Silver Tax Is Not a Valid Excise.

The Constitution gives Congress power to levy two classes of taxes: (1) "direct" and (2) "duties, imposts and excises". The first class (except for income taxes) must be apportioned according to the census; and the second class must be uniform. It is therefore necessary in each case involving other than an income tax to classify the tax according to the Constitutional line of distinction.

Excises are historically taxes upon the carrying on or doing of business, or upon the exercise of a particular privilege. From the time of *Hylton* v. *U. S.*, 3 Dall. 171, this Court has applied the historical test to determine whether a particular tax is an excise. *Tuller*, in "The Taxing Power" (1937), says, p. 90:

> "For the present, it is sufficient to say that the term 'excise', as used in the Federal Constitution is clearly used in the *historical sense*. There was no other sense

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[7] *United States* v. *Hudson*, Government Brief in the Supreme Court, pp. 40, 41; "It is immaterial whether this tax would be classified as an income tax for all purposes. See *Flint* v. *Stone-Tracy Co.*, 220 U. S. 107, 151; *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U. S. 271, 284; *Educational Films Corp.* v. *Ward*, 282 U. S. 379, 387-8. So far as its retroactive effect is concerned, it stands on precisely the same footing as an income tax."

in which to use it. Then, as now, the term had no generic meaning. It had no settled historic meaning in the United States, for relatively few excises had been levied here, and such as had been were based on the English system. But it had a history of 144 years in England. Hence, the term refers to the kind of taxes which were known as excises in England at the time of the adoption of the Constitution and prior thereto and which in that country had been levied and collected as excises." (Author's italics.)

A tax on the profit from the sale of personal property has always been considered a direct tax. *Pollock* v. *Farmers Loan and Trust Co.*, 158 U. S. 601; *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1. So classified, such a tax cannot also be an excise.

In *Nicol* v. *Ames*, 173 U. S. 509, this Court, in sustaining a tax upon sales at a grain exchange, pointed out that it was a privilege tax and not a tax upon the thing sold or upon the proceeds of the sale thereof. The following language clearly points out the distinction between an excise and a direct tax, placing a tax upon the profits from the sale of property in the latter category:

> "It is not laid upon the property at all, nor upon the profits of the sale thereof, nor upon the safe itself considered separate and apart from the place and the circumstances of the sale" (173 U. S. at 520).
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> "A tax upon the privilege of selling property at the exchange and of thus using the facilities there offered in accomplishing the sale differs radically from a tax upon every sale made in any place. The latter tax is really and practically upon property. It takes no notice of any kind of privilege or facility, and the fact of a sale is alone regarded" (p. 521).

The silver tax does not become an excise tax by virtue of its form or statutory description. This point was made

in *Dawson* v. *Kentucky Distilleries Co.*, 255 U. S. 288, 292 and 294, as follows:

> "The name by which the tax is described in the statute is, of course, immaterial. Its character must be determined by its incidents; * * * To levy a tax by reason of ownership of property is to tax the property. (Citing authorities.) It can not be made an occupation or license tax by calling it so."

It is to be observed that in the *Hudson* case the Government did not argue that the silver tax was an excise; and this Court did not so characterize it.

As applied in the case at bar, the silver tax has been imposed upon isolated sales of silver by a taxpayer who was not engaged in the business of buying and selling silver bullion. It may not be sustained as an excise because (1) it is neither in form nor substance similar to excises as they have been known in the historical sense; and (2) it is payable by all persons without distinction as to whether or not they are engaged in the business of buying and selling silver bullion, and not as a charge for the privilege of engaging in such business; and (3) it is not imposed upon every transaction in silver bullion, even by those engaged in the business.

C. The Decision Below Was Erroneous as a Matter of Construction and Application of the Statute to the Facts in the Case at Bar.

The statute imposes the tax "on all transfers of any interest in silver bullion".

Petitioner's interest in silver bullion consisted of approximately two million ounces. The Court of Claims has sustained an interpretation of the statute which emphasizes the words "all transfers" and ignores the requirement that the transfer that is taxable is of an "interest" in silver bullion. The wording of the statute has been construed

by the court below as the equivalent of "every transfer of silver bullion".

The statute defines the term "interest in silver bullion" to mean "any title or claim to or interest in, any silver bullion or contract therefor". This does not clarify the problem presented in the case at bar. It remains a factual question whether the aggregate of several purchases and sales constitutes the transfer of a single interest or several interests.

Factually it is beyond doubt in the case at bar that the two million ounces of silver bullion owned by petitioner constituted a single and undivided interest. The findings of the Court of Claims clearly establish that the silver bullion was acquired with a single fund, for a single purpose, and was disposed of without change of that purpose (Finding of Fact, Number 19; R. 14). Its sale in chronologically separated lots, for the practical reasons shown by the record, did not change it into several interests, separately taxable. The business purpose in selling in separate lots is a proper factor for consideration. *Helvering* v. *Elkhorn Coal Co.*, 95 F. (2d) 732, 738; Cert. Den., 305 U. S. 605.

Without reviewing the record at length, it should be noted that the evidence and the findings sustain petitioner's position that the sale of the silver bullion in instalments did not, either from the subjective or objective point of view, break up the two million ounces into separate and distinct interests (Findings of Fact, Numbers 13, 14, 15, 16, 17, 18 and 19; R. 11-14). This position has been recognized and approved in connection with the purchase of the silver, as the Bureau of Internal Revenue accepted the average cost of the several instalments purchased as the basis for computation of the gain or loss on each instalment sold. Having recognized that the purchase in instalments constituted an appropriate method of accumulation of a single interest of two million ounces of silver bullion, there was no

justification for disregarding the unity of the several sales which were required for its disposition. The selling period was approximately the same as the buying period, and the market conditions at the time of the sales necessitated selling in instalments, even more than the conditions existing at the time of purchase required its acquisition in that manner (Findings of Fact, Numbers 17 and 18; R. 13-14).

If the Bureau's construction of the statute sustained by the Court of Claims is correct, it would have been possible under the statute for a taxpayer to have sustained a net loss on its purchase and sale of an interest in silver bullion, and yet to have been subjected to a tax. It is scarcely credible that such a result should have been contemplated in connection with the acquisition and disposal of such an interest as petitioner had.

We complain not in respect to the statute, which is susceptible of a fair interpretation, but in respect to the interpretation which has been placed upon it in applying it to the facts of this case. The construction of the statute adopted by the Court of Claims is not a practical, common sense application of the tax to the facts presented in the case at bar, and the determination below should be reviewed in order to correct a manifest error.

D. The Disallowed Expenses Were Necessary in Connection With the Acquisition, Holding and Disposing of the Silver Bullion and Were Not in the Nature of Overhead.

The Court of Claims said (R. 20) that legal fees are not specified as allowable in the statute, and therefore are not properly deductible in determining the taxable profit.

The statute, however, permits deduction of "necessary expenses actually incurred in holding, processing, or transporting the interest in silver bullion". The legal fee was incurred through the retainer of special attorneys for advice

in connection with the acquisition, holding and disposal of the silver (Finding of Fact, Number 21; R. 14-15). It was not practicable for petitioner to engage in this transaction without legal advice as to its liability for taxes, both in connection with the acquisition and in connection with the sale thereof, and as to its rights and obligations, in view of the silver policy of the Government. The record shows, without contradiction, that the services rendered related to these questions, and it was stipulated that the fee paid was reasonable in amount. The attorneys were not petitioner's regular counsel, and the fee paid was a special expense which would not have been incurred had it not been for the silver transaction. It cannot be said, therefore, that the fee was in the nature of overhead. It was a necessary expense actually incurred in holding the interest in silver bullion. Under the circumstances, there was no justification for denying the deduction of the fee as a necessary expense, and the amount of additional tax paid by reason of such disallowance should have been refunded.

Conclusion.

The determination of the Court of Claims is based upon an interpretation of the silver tax statute which renders it unconstitutional as a direct and unapportioned tax on gross receipts, and not upon income. The determination ignores the evidence and the findings establishing the single and indivisible character of petitioner's interest in silver bullion. In denying the right of the taxpayer to balance losses on similar and related transactions against taxable profits, the Court of Claims has opened the door to a type of transactions tax which cannot conceivably be deemed a tax on income, and which does not legitimately fall within the constitutional scope of an excise. That result is not warranted by the statute, and is not necessary as applied to the facts of the case at bar.

For these reasons it is respectfully submitted that a Writ of Certiorari to the Court of Claims should be granted herein.

Respectfully submitted,

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Dated: New York, December 31, 1940.

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